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Car Trouble

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Abstract

By common account, the reorganizations of *Chrysler* and *General Motors* were extraordinary cases, very much alike, but different from any other. Government intervention on such a scale is not likely to recur and, given their peculiar character, these bankruptcies offer few lessons for corporate reorganizations as a general matter. This essay suggests that this perception is fundamentally wrong.

Each case presented a radically different challenge for the bankruptcy system. Moreover, these two distinct challenges, far from being unusual, are not particularly related to the fact of government involvement and are likely to recur many times.

The debate over speedy sales of businesses in Chapter 11 is over. Sales are now the norm in large reorganizations. Instead of asking whether there should be sales in bankruptcy, we need to ask how to police various forms of abuse. The principal types of abuse derive from where the controlling creditor lies in the capital structure.

In both *Chrysler* and *General Motors,* the government was simply a large creditor exercising control over its debtor and pushing for a speedy sale of the assets. But because the government occupied different places in the capital structures in the two cases, the legal challenges were altogether different. Together they capture the issues central to large Chapter 11 cases today.

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At the start of 2009, General Motors and Chrysler were bleeding to death.[1] Maintaining either business as a going concern required a massive infusion of capital—tens of billions of dollars—no one in the private market was willing to provide. Many have focused on the decision of first the Bush and then the Obama administration to keep these businesses alive.[2] Rather than join this debate, this paper focuses on the use of the bankruptcy process to effect the bailout and in particular on what it tells us about corporate reorganizations going forward.[3]

In December 2009, the Supreme Court vacated the Second Circuit's decision in *Chrysler*.[4] As the Court was not compelled to take this step, one might draw from it the suggestion that the Supreme Court meant to signal that *Chrysler*—and *General Motors*—are extraordinary cases, very much alike, but different from any other. They would have been bankruptcy's *Bush v. Gore* if they reached the Supreme Court on the merits, but they did not. From the perspective of bankruptcy law, they are non-events. Government intervention on such a scale is not likely to recur and, given their peculiar character, these bankruptcies raise few issues of moment for corporate reorganizations as a general matter.

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[1] General Motors, by its own excessively optimistic predictions, was going to burn through $18 billion in cash within a year. *See* General Motors Corporation, *2009–2014 Restructuring Plan Presented to U.S. Department of the Treasury As Required Under Section 7.20 of the Loan and Security Agreement Between General Motors and the U. S. Department of the Treasury Dated December 31, 2008*, Table 12, at 30 (2009), *available at* http://www.financialstability.gov/docs/AIFP/GMRestructuringPlan.pdf. Chrysler losses were considerable, but less spectacular. It was a smaller firm and was therefore losing less. In addition, as it was about to shut down production for a number of months due to a massive inventory of unsold cars, Chrysler had less immediate cash needs. *See* Chrysler, *Chrysler Restructuring Plan for Long-Term Viability*, at 39 (2009), *available at* http://www.financialstability.gov/docs/AIFP/chryslerRestCoverSum.pdf.

[2] For an insider's defense, see STEVEN RATTNER, OVERHAUL: AN INSIDER'S ACCOUNT OF THE OBAMA ADMINISTRATION'S EMERGENCY RESCUE OF THE AUTO INDUSTRY (2010). For an overview that places the rescue in the context of the automobile industry as a whole, see PAUL INGRASSIA, CRASH COURSE: THE AMERICAN AUTOMOBILE INDUSTRY'S ROAD TO BANKRUPTCY AND BAILOUT—AND BEYOND (2010).

[3] One can raise, of course, a broad objection to the government's use of the bankruptcy process in both Chrysler and General Motors. The bankruptcy process allowed the federal government to funnel billions to workers, tort victims, and retirees that it could not have given them directly. The bankruptcy process, so this argument goes, provided a conduit, a means of laundering funds, to a politically powerful constituency that it could not otherwise have paid off. Jim White has been the strongest proponent of this view. I do not engage in this debate either.

[4] *See* Indiana State Police Pension Trust v. Chrysler LLC, 130 S. Ct. 1015 (2009).

This perception is fundamentally wrong. First, the cases are not at all alike. Each case presented a radically different challenge for the bankruptcy system. Moreover, these two distinct challenges, far from being unusual, are not particularly related to the fact of government involvement and are likely to recur many times. Together they capture a tension central to large Chapter 11 cases today.

The bankruptcies of Chrysler and General Motors, quite apart from debates about government intervention in the marketplace, underscore the need to recognize a fundamental shift in large reorganization practice over the last fifteen years. The debate over speedy sales of all the assets of the business as a going concern is over.[5] Sales are the norm in large reorganizations that are anything other than a confirmation of a debt restructuring reached outside of bankruptcy. The debate now centers on how the sales should be conducted.

Instead of asking whether there should be auctions in bankruptcy, we need to ask how to run them. At the time of the bankruptcies, the government was already a large investor in both *Chrysler* and *General Motors*. As far as the bankruptcy process itself was concerned, the government was, to a very large extent, simply a large creditor exercising control over its debtor. Bankruptcy law tries to ensure that those who have such control do not abuse it. The types of potential abuse derive in the first instance from where the controlling creditor is in the capital structure. In *Chrysler,* the government held a junior stake, while in *General Motors* it held a senior one. These are the two principal problems we face in designing an effective sales process: Ensuring that, when junior investors control the sale, they do not put seniors at risk and ensuring that, when seniors control, juniors are protected.

I. Chrysler

The precipitating event for the bankruptcies of both Chrysler and General Motors was a credit crisis that depressed consumer demand for automobiles. Fifteen million cars and light trucks had been sold in North America every year since 1994, but in the last part of 2008, the annual rate dropped over the course of a few weeks to less than ten million a year, a level not seen since the 1960s.[6] And it quickly became clear that the rate would not return to its previous rate for years. A drop of

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[5] *See* Douglas G. Baird & Robert K. Rasmussen, *Chapter 11 at Twilight*, 56 STAN. L. REV. 673 (2003).

[6] *Chrysler Restructuring Plan, supra* note 1. at 34 ("decline in SAAR levels in 2008 has been at an unprecedented pace–dropping 5.8 million units from 15.6 million in January 2008 to a 9.8 million monthly annualized rate in January 2009").

this magnitude had never happened before, not even during the 1930s, and it had never happened so suddenly. As my discussion of General Motors's bankruptcy will make plain, this collapse in demand was not the whole story, but by itself it was enough to seal Chrysler's fate.

Even with a rise in demand of several million cars and trucks per year, Chrysler had no future as a going concern. By the most optimistic accounts, there was massive overcapacity in the domestic automobile industry.[7] Some of that capacity had to go off-line. In a market economy, the capacity that should go offline is the least efficient and the least valuable and this was Chrysler. Chrysler was making the worst cars, and there was no prospect that this would change. In sharp contrast to Chrysler's previous reorganization in 1980, where Lee Iaccoca's Chrysler had the K-car and the minivan in the wings, Chrysler had nothing waiting and the cars were not a type people wanted.[8] Without cars that could compete on equal terms, Chrysler could not survive. At the time that the Bush administration decided to extend credit to Chrysler, a few might have thought otherwise. By the time the Obama administration took power, no one did.

The question for the Obama administration was not whether to shut Chrysler down, but how to do it. It considered two alternatives. One was to close Chrysler immediately. The other was to allow Chrysler to fail slowly over the course of several years in a way that coincided with Fiat's entry into the U.S. market. With luck, Fiat could make its cars at factories that had been producing Chryslers while taking advantage of part of Chrysler's existing distribution system. A few of Chrysler's old workers might be able to keep their jobs. The Jeep brand name could continue, though likely not the manufacturing operations that were making Jeeps. Some other Chrysler brands might also survive.

The Obama administration ultimately opted for the second option, even though it required several billion dollars and came with no guarantee of success—success being defined as Chrysler slowly morphing into Fiat without many noticing. Success, so defined, depends first on whether the automobile market recovers quickly enough. It also depends on whether Fiat culture and technology can marry well with old Chrysler's culture and technology. Fiat's ambitious plans also assume

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[7] J.D. Power and Associates estimated North American utilization at 50% of capacity in 2009. *See* Liam Denning, *Detroit Risks Falling Back Into Temptation*, Wall St. J., Nov. 25, 2009, at C16

[8] *See* Denning, *supra* note 7. (Chrysler to replace only 8.3% of its fleet each year between 2010 and 2013 compared with 11% at GM and 25% at Ford).

that the market share of existing Chrysler cars will increase.[9] Some in the administration who thought the gamble, however bad, was worth taking, and they were able, after some effort, to persuade the President to take it.[10]

As Chrysler had no value as a going concern, Fiat was not willing to pay a positive price for it. Before Fiat would agree to run it in exchange for a large equity interest, the federal government had to inject billions of dollars into the business and also buy peace with the labor unions and other constituencies. Moreover, Chrysler needed to rid the business of its existing liabilities as well as dramatically alter its dealer network.

Bankruptcy seemed a useful way to bring about all of this. After cutting a deal with the unions, the Auto Task Force arranged for Chrysler to file a bankruptcy petition.[11] At the same time, it injected cash from TARP into a new subsidiary of Fiat called New CarCo. Fiat put in no cash of its own. New CarCo appeared on the first day of the case with a $2 billion bid to buy the assets of Chrysler free and clear of any existing claims, including secured claims, as well as any obligations to the old dealers. As long as the judge approved the sale procedures and no competing buyer appeared, New CarCo would become the owner of those Chrysler assets that were useful to Fiat.

Finding a buyer before the bankruptcy to assimilate the assets of a distressed business into its own is a familiar theme of large reorganizations. The challenge for the court in such cases in one of ensuring that the sales process is one that respects the rights of those who are not in control of the debtor and who object to the sale. And, of course, there were quite a number who objected. This sale left tort victims who suffered injuries before the bankruptcy petition out in the cold. Dealers who were no longer wanted were abandoned. The secured bondholders were paid only thirty cents on the dollar. Each of these parties appeared and objected. Were any of their rights violated? Did anyone get paid

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[9] Chrysler expects its market share to rise from 9.5% to 13.5% between now and 2013. *See* Denning, *supra* note 7.

[10] The Task Force recommended the second liquidation option to Obama, although without great enthusiasm. One of the dissenters, Austan Goolsby, now the chair of the Council of Economic Advisors, continued to press for immediate liquidation. Obama postponed his decision on Chrysler and insisted on a special evening meeting where the question could be debated at length. Only after that meeting did he opt for the slow-liquidation option. *See* Steven Rattner, *The Auto Bailout: How We Did It*, FORTUNE (October 21, 2009).

[11] The components of the reorganization plan are summarized in In re Chrysler LLC, 405 Bankr. 84 (Bankr. S.D.N.Y. 2009).

who should not have been? Was there anyone who did not get paid who should have been?

The question with respect to the existing tort victims is easy as matter of existing law. Tort claims are ordinary general claims that take a back seat to those of secured creditors and no one seriously argued that Chrysler was worth more than its secured creditors were owed. If there is not enough to pay the secured creditors, the tort victims are not entitled to anything.

It is easy to argue that the law should be otherwise. Tort law should hold firms liable only for acts that impose unreasonable costs on others, but as long as this happens a superpriority lien would neither limit desirable investment nor make reorganization more difficult. Indeed, faced with the risk of being primed by tort victims, investors will ensure that firms take sensible precautions. And there is no unfairness to them, as they can adjust the terms of their investments to take account of potential tort liability. Of course, if tort liability were not sensibly defined, it might deter behavior on the part of firms that is socially desirable, but this is a consequence of a bad tort law, not of superpriority. The obligation to pay tort victims would affect only the distribution of the firm's assets.

If changes were required in the Bankruptcy Code to accommodate superpriority tort liens, they would be modest. While the costs of adjudicating tort liability may be substantial, these costs exist outside of bankruptcy, as well as inside. In the extreme case, superpriority tort liens may themselves exceed the value of the firm, but this means only that the costs of administering the bankruptcy will be borne by the tort victims. The process can be administered even in these circumstances. More to the point for purposes of this paper, there is nothing about the priority accorded tort victims that is peculiar to the government's involvement in the case.

The automobile dealers who were abandoned argued that Chrysler should not be able to extinguish automobile franchises in bankruptcy. They asserted that the decision to terminate their dealerships made no economic sense. Car manufacturers do not subsidize them. If they are losing money from running their dealerships poorly, it is their money that is being lost. This argument, however, is both orthogonal to the legal argument and wrong on the merits.

Every manufacturer needs a way of bringing its product to market. For some, the strategy involves finding independent retailers. For some, there is complete vertical integration. For others, it is a mixture of the two. The optimal distribution mechanism may change. Microsoft, for example, is now creating its own retail outlets. Regardless of the organizational structure, a manufacturer needs to have sales outlets in the right-sized facilities, run by the right people, located in the right places. Courts are poorly positioned to second-guess these decisions.

Moreover, it is easy to see that Chrysler's dealer network was part of its problem. It was put in place in a different era. In 2009, it was completely out of step with what Fiat needed. Even if it could free itself of deeply embedded norms, state and federal franchise laws made it hard to restructure the distribution channel. Once established, dealers can be terminated only for cause. Radically different channels for selling cars—such as through the Internet without any dealer intermediation—are not possible. Locking an industry into a hopelessly inefficient method of distribution in the age of Walmart makes little sense. Car manufacturers should be able to experiment with different ways of selling their goods just like computer makers.

Conventional wisdom suggests that a debtor should, in the exercise of its business judgment, be able to use bankruptcy to bring about these kinds of changes. By the usual account, dealerships are executory contracts that can be rejected, and the judge in *Chrysler* accepted this conventional wisdom. The dealers might have been able to press their case more forcefully than they did. There is good reason to think this conventional wisdom wrong. Chrysler's complaint is essentially with nonbankruptcy legal protections that automobile dealers enjoy. It is far from clear that bankruptcy law should be in the business of second-guessing these rules, rules that may have the effect of giving automobile dealers something akin to a property right. Chrysler had not only promised to keep delivering cars at a specified price, but also conveyed the right to use the Chrysler name/brand in a particular geographic area. The franchise is a form of property. Once property is sold, it cannot be recovered in bankruptcy by virtue of the ability to reject executory contracts. The power to reject an executory contract is not an avoiding power.[12]

Whether the franchises were purely contractual or contractual coupled with the conveyance of a property interest itself requires closer examination than any of the parties gave it. This question illustrates a long-standing tension in bankruptcy law and the way that the treatment of executory contracts is, as a general matter, one of the worst flaws in the Bankruptcy Code. But the judge here broke no new ground in allowing these dealerships to be terminated.

[12] *See* Michael Andrew, *Executory Contracts in Bankruptcy: Understanding "Rejection,"* 59 U. Colo. L. Rev. 845 (1988).

It might seem that the way that secured creditors were treated was what was most seriously wrong in *Chrysler* and that their treatment was a direct consequence of government intervention. Secured creditors are supposed to be paid in full before those junior to them get paid anything. This is bankruptcy's absolute priority rule. Put in place first in the 1930s, it has become one of bankruptcy's central axioms.[13] But it is not at all clear that the absolute priority rule was violated.

In the first instance, the secured creditor's right to absolute priority, like any other right, is one that can be waived in the bankruptcy process itself. This seems to have happened here. Secured creditors in *Chrysler*, as a group, consented to the Task Force Plan. As in most large financings, the secured creditor in *Chrysler* was not a single financial institution, but rather a consortium of lenders who had joined forces. The loan agreement set out how they would coordinate their efforts. It explicitly provided that the administrative agent was to follow the wishes of the majority in deciding whether to block the sale of the collateral.[14] Over ninety percent of the consortium in *Chrysler* agreed to accept the government's offer of $2 billion. They told the administrative agent not to block the sale, and he followed their instructions.

Those who opposed the sale were outvoted. They needed to explain why the loan agreement did not bind them. They invoked a provision in another part of the loan agreement that prevented "waivers, amendments, supplements or modifications" to the loan agreement without their consent. This was not a strong argument on the merits, and the judge likely interpreted the loan agreement correctly. But whether he did or not, is quite beside the point. Interpreting such agreements among creditors in the same class is a job the bankruptcy judge routinely faces in large cases. It has nothing to do with government involvement in the case.

The dissident secured creditors argued further that the vote of the majority was tainted. The majority of investors that approved the sale had received TARP funds. They were not consenting in order to maximize the value of their secured claim, but rather because they feared re-

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[13] *See* Case v. Los Angeles Lumber Products Co., 308 U.S. 106 (1939). It is sometimes asserted that the absolute priority rule has deeper roots. This is wrong. *See* Douglas G. Baird & Robert K. Rasmussen, *Boyd's Legacy and Blackstone's Ghost*, 1999 SUP. CT. REV. 393, 416-17.

[14] *See* In re Chrysler LLC, 405 Bankr. 84, 101 (Bankr. S.D.N.Y. 2009). As I discuss below, secured creditors control whether a sale takes place to a third party by the device of credit-bidding. Ensuring that this right exists, not an issue in *Chrysler*, is an important element of protecting secured creditors when those junior to them are in control.

percussions elsewhere if they refused to do the government's bidding. It is hard to have much sympathy for this argument. First, the minority investors were not babes in the woods. They should never have thought that J.P. Morgan was going to do anything other than follow its own self-interest if the deal went sour. While these particular circumstances were not foreseeable, the dissenting creditors could anticipate that there were any number of ways in which J.P. Morgan's interests might diverge from their own. This is a class of risk for which sophisticated investors are compensated. We might have a legal rule that required controlling creditors to look out for the interests of the minority, but we do not. While controlling shareholders in a solvent corporation owe fiduciary duties to minority shareholders, there is no corresponding duty in the case of creditors.

I have argued elsewhere that allocating fiduciary duties in this fashion is unsound.[15] But there is no issue of unfairness. It should not have come as a surprise to any investor in this deal that J.P. Morgan would be looking after its own interests in deciding whether the assets were sold. It was incumbent on the dissenters to bargain for a different contract if they wanted one. And even if J.P. Morgan and the other lenders broke their obligations under the loan agreement in their instructions to the administrative agent, the remedy would seem to be a state-court contract action.

The duties investors in the same slice of the capital structure owe each other are contractual. The problem that investors face in coordinating their actions with one another does not implicate bankruptcy process beyond making it important that bankruptcy judges enforce contracts as written, something they are generally inclined to do.[16] A modern bankruptcy judge is not likely to be biased against one or the other in assessing a battle between investors at the same priority level.

Even if the secured creditors as a group had not consented, it is still not obvious that anything is amiss. To be sure, New CarCo was planning to make payments to retiree pension funds and various suppliers. Indeed, it later even assumed Chrysler's tort liabilities. But New CarCo was never in bankruptcy. Chrysler, the debtor that filed the bankruptcy petition, gave everything it had to the secured creditors. It did not pay its general creditors anything. It sold its assets to New CarCo for $2 billion in cash. The absolute priority rule required that all of this cash go to the secured creditors and it did. Why should Chrysler's secured credi-

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[15] *See* Douglas G. Baird & M. Todd Henderson, *Other People's Money*, 60 STAN. L. REV. 1309 (2008).

[16] *See, e.g.,* In re Metaldyne Corp., 409 Bankr. 671, 677 (Bankr. S.D.N.Y. 2009).

tors be able to complain that New CarCo, a completely different entity, is giving money to some who had once been creditors of Chrysler?

I owe you a bunch of money, and you have a security interest in everything I own. My only asset is a Van Gogh. I file for bankruptcy and the trustee puts my painting up for sale. And there are two bidders. One bids $1 million. He is going to put the Van Gogh above his sofa. The other bids $2 million. He is a loving son who plans to give it to his mother so she can put it above her sofa. Confronted with these two bids, it would seem that my bankruptcy trustee should take the $2 million bid. It is completely irrelevant that the mother is also a general creditor in my bankruptcy. She is receiving the asset because her son was the high bidder, not because she was my general creditor. Creditors of a seller should not care how the buyer will use the assets, nor how sentimental, generous, or stupid he is.

New CarCo offered to pay more for Chrysler's assets than anyone else. The secured creditors should count their good fortune. Chrysler had no value as a going concern.[17] Far from receiving less than the business was worth, the secured creditors were receiving more. You have to expect that someone who is paying you too much will bestow largess on others as well. Usually when you find a buyer who offers you more than he should, you do not complain that he is being unnecessarily generous to others. You take the money before he recognizes his idiocy.

Of course, one can argue that the willingness of the government to invest billions of dollars in a business that had no value as a going concern has the effect, over the long-term, of distorting investment decisions. But the distortion here arises from giving the secured creditors too much, not too little. It makes them too inclined to invest in declining industries. The complaint that the government intervention discourages investors in a particular industry gets things backwards.

The principal obligation New CarCo assumed was the support of Chrysler's retiree benefits. There is a second way to justify these. The retirees may have been paid not because the government wanted to bestow largess on them nor because they were prepetition creditors, but because the UAW had the ability to shut the firm down postpetition. Unlike some other unions, the UAW protects its retirees, and it might not have been possible to run Chrysler as a going concern without cutting a deal that included the retirees. In theory, Chrysler could reject the

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[17] Chrysler may, however, have had a positive value if it were liquidated. I return to this issue below.

collective bargaining agreement and the retiree benefits in bankruptcy.[18] It could then hire replacement workers willing to cross picket lines. But it is hard to see how Chrysler could have survived such a shock.

Let us assume that Chrysler would be worth $5 billion in a world without the UAW, but the UAW can credibly threaten to shut it down unless $3 billion is paid to the retiree benefit fund. How much is Chrysler worth as a going concern? In the counterfactual *Twilight Zone* world in which the UAW does not exist, the firm is worth $5 billion, but on Planet Earth, it is worth only $2 billion. The need to pay the retirees $3 billion is a cost of doing business—no different from the money needed to pay what might seem high prices for zoning variances, concrete, or garbage collection.[19] Every buyer takes these into account in making a bid. A rational buyer pays $3 billion to retirees not on account of the prepetition debt owed them, but because of what it receives from them postpetition. The debtor's senior creditors cannot complain that others are being paid for something (labor peace) that they neither own nor control. The deal the government cut with the UAW might have been the deal cut by anyone committed to keeping the business running. In this sense, the government was not behaving any differently from a private creditor trying to maximize its return on a bad investment.

The secured creditors as a group, however, would have grounds for complaint if Chrysler were more than $2 billion if liquidated. The government demanded that Chrysler shop the company extensively before settling on Fiat, but less clear is how much it required Chrysler to explore a piecemeal sale of the assets. The rule of thumb when you liquidate a company is that you realize ten percent of book value. That might not seem like much, but in the case of Chrysler, it was more than twice New CarCo's bid. Creditors should not much care who the buyer happens to be or what plans the buyer has for the assets, but they should care about ensuring that the sale brings top dollar. They should be able to object to a sale of the business as a going concern if more could have been realized by selling it off in pieces.

Chrysler owned a lot of real estate. It had a valuable trademark in Jeep. Its transmission business was well respected. There were accounts receivable in the billions of dollars. To be sure, the value of these assets had to be discounted. Real estate values had plummeted and land used

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[18] Sections 1113 and 1114, however, may the process of rejecting these contracts harder than it is for ordinary contracts.

[19] There is nothing new here. Dangerfield makes the same point. See http://www.youtube.com/watch?v=YlVDGmjz7eM&feature=related (noting the need to account for such expenses as costs of business much like any other).

for manufacturing can be a toxic waste site that has a negative value. A Chinese company might not be willing to pay much for the Jeep brand name if it feared that a hostile Congress might not allow the cars to be exported to the United States. Many accounts would prove uncollectable if Chrysler shut down as Chrysler's liquidation would likely trigger a liquidation of the account debtors. A promise from a Chrysler dealer is likely worth even less than Chrysler's own promise. Nevertheless, a piecemeal sale of assets would likely fetch *something*. Hence, the question was not whether New CarCo was paying a fair price for Chrysler as a going concern. As a going concern, *any* positive price would be fair. The proper question rather is whether the amount bid exceeded the value of Chrysler if broken up piecemeal.

Chrysler did pay a valuation expert who, in return for a fee of $10 million, said that, if liquidated, Chrysler would be unlikely to yield more than $2 billion after the costs of the sale were taken into account. But the amount someone would pay to acquire Chrysler's assets with the intent to liquidate them is not a question that should be left to expert testimony. It should be tested by the market.

In short, the key question in Chrysler is not whether there should have been a free-and-clear sale, but rather whether enough was done to get the best price.[20] The government had Chrysler propose bidding procedures that defined as a "qualified bid" only those that assumed the obligations that New CarCo was planning to assume. Many of these, such as promises to retirees, made sense if the business was continuing as a going concern, but not otherwise. The debtor could consider non-qualified bids in the exercise of its fiduciary duty only after consultation with both the U.S. Treasury and the UAW. This falls somewhat short of affirmatively welcoming liquidating bids. The failure of the bankruptcy judge to open the bidding process more contrasts sharply with practice elsewhere. For example, the judge in the *Sun Times* bankruptcy insisted (over objection) that liquidating bids be entertained. He did not expect any and none appeared, but he wanted to cut square corners.

Chrysler is emblematic of a larger class of cases in which the junior creditors are in control and one needs to ensure that the sale procedures protect the senior creditors. This may not be that hard. In theory, it is

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[20] Barry Adler, Mark Roe, and David Skeel have made this point. *See* Barry E. Adler, *Reassessment of Bankruptcy Reorganization after Chrysler and General Motors, A Chapter 11 at the Crossroads: Does Reorganization Need Reform?*, 18 AM. BANKR. INST. L. REV. 305 (2010); Mark J. Roe & David Skeel, *Assessing the Chrysler Bankruptcy*, 108 MICH. L. REV. 727 (2010).

not possible to sell a company over the objection of a senior creditor for less than the amount of its claim.

Let us assume that the secured creditor is owed $10. The debtor has found a stalking horse bidder who is offering $2. At this point, the secured creditor can simply go to a bank, obtain a $10 credit line, and make a $10 bid. If it proves the high bidder, the secured creditor, as the high bidder, draws on the credit-line, turns over $10, and becomes the owner of the company. But now, wearing its hat once again as the senior secured creditor, it is entitled to receive the $10 back again, as it is entitled to all the proceeds of the sale. Once it receives this money, it can repay the loan. The transaction with the bank is a wash. If a competing bidder tops its bid, the senior creditor will not have to draw on the credit line at all, and it will be paid everything it is owed. The senior creditor's ability to borrow for a day and join the bidding ensures that it will receive everything it is owed or, when the firm is worth less than this amount, the entire firm.

Secured creditors do face significant transaction costs in orchestrating a cash bid. To minimize these, the Bankruptcy Code allows the secured creditor to forgo putting up cash. It can simply bid the amount of its claim (and avoid the transaction costs and potential liquidity constraints associated with obtaining a day loan). The ability to credit bid, however, may fall short of giving secured creditors who lack control over their debtor complete protection. First, secured creditors need to be able to act collectively. When the most senior tranche is not a single creditor, but a diverse set of creditors who are constantly trading in and out of the case, it may be hard for them to act as one. Even though they occupy the same place in the capital structure, a hedge fund, a bank, or a special purpose vehicle securitizing the claim can have radically different objectives.

In addition, credit bidding protects the senior creditor only if it has the ability to take over the assets in the event that it proves to be the high bidder. Not only must a mechanism allow someone competent to run the operation, but doing this even for a short period of time (to allow, for example, a piecemeal sale) may require cash. Not all the members of the lending group may be willing to do this.

Whatever difficulties secured creditors face in bidding, however, the Bankruptcy Code should minimize them. Developments after *Chrysler* have put the matter in doubt. While credit bidding is a right explicitly granted to secured creditors under §363, sales can also be conducted under §1129, where the right to credit bid is less clear. The most recent case—decided by the Third Circuit—involved the *Philadelphia Inquirer*. The secured creditor was owed hundreds of millions. No one thought the company worth nearly that much and everyone agreed that there should be a sale and that the secured creditors should get every penny.

The managers found a stalking-horse bidder who has agreed to keep them on. This buyer offered the senior creditors $30 million in cash. The senior lenders thought they would do better taking over the business themselves and throwing out the existing management. The senior lender was a consortium of several dozen financial institutions and hedge funds. It was hard for them to assemble the resources to make a competing bid, even though they would receive it all back. Taking advantage of this, the debtor proposed a plan of reorganization in which a sale is part of the plan of reorganization, not under §363, and argued that it did not have to give them an opportunity to credit-bid.

The Third Circuit agreed.[21] The Fifth Circuit has found it similarly unavailable.[22] Section 1129 is written in the alternative and allows the debtor to propose a plan in which the secured creditor is given, in lieu of its right to credit bid, the "indubitable equivalent." As credit-bidding allows the secured creditor to gain control over the asset (including the right to sell it to whomever and however it pleased), it is mystifying how any plan that forced the secured creditor to take a particular bid from a particular buyer provided the "indubitable equivalent." A sale for a fixed price to a buyer in league with existing managers hardly seems the same as outright ownership.

The contrary argument that carried that day rested merely on the language of the statute. Given that it was written in the alternative, *some* plan must provide the indubitable equivalent of credit bidding. One could not categorically deny the debtor to present such a plan. The debtor was entitled to show its plan passes this threshold and a conclusive presumption against the plan was therefore inappropriate. As a matter of narrow and literal statutory interpretation, the argument had some

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[21] *See In re* Philadelphia Newspapers, LLC, 599 F.3d 298, 300 (3d Cir. 2010). One should emphasize here, however, that denying secured creditors the ability to credit bid merely imposes additional transaction costs, costs that the secured creditors may ultimately overcome. This proved ultimately the case in *Philadelphia Newspapers*. A group of the secured lenders pooled their resources and went to the auction and prevailed in the end. *See* Steven Church, *Philadelphia Inquirer Lenders Best Perelman in Bankruptcy Court Auction*, Bloomberg News, Sept. 23, 2010, available at http://www.bloomberg.com/news/2010-09-23/philadelphia-inquirer-lenders-outbid-raymond-perelman-for-newspaper-owner.html.

[22] *See In re* Pacific Lumber Co., 584 F.3d 229, 296 (5th Cir. 2009).

force, but it otherwise has little to recommend it, especially as there was little chance for the creditors to object to the plan a second time.[23]

In addition to ensuring that creditors that find themselves in the position of the creditors in *Chrysler*, we must also worry about those cases in which the senior creditors are the ones with control. The ability to credit bid combined with control poses a threat to the rights of junior investors, at least in those cases in which it is not self-evident that they are out of the money. How to protect junior investors in these circumstances is an issue that has long been of concern to the law of corporate reorganizations and this was the problem that arose in *General Motors*. I turn to it next.

II. Innovation, Market Structure, and Economic Distress

The modern automobile goes back to the Model T. The image some have of the Model T is Jedd Clampet and *The Beverly Hillbillies*—a rickety contraption held together by bailing wire and chewing gum. That is fundamentally wrong.[24] The Model T was a tough, durable car. After a hundred years, quite a few are still running. More importantly, it was a great technological break-through that introduced a design that became the template for automobiles that lasted until the 1970s.[25] The Model T's genius lay in its simplicity. Instead of a carriage on wheels with a motor attached, the car consisted of three elements: the frame, an encased drive train, and the body. The ability to change the body design and interior finishings allowed for the production of cars that looked quite different, but were fundamentally the same.[26]

In the decades after Henry Ford, the icon of automotive innovation was Harley Earl, who reigned at General Motors from the 1930s through the 1950s. General Motors featured him in its advertising even within the last decade. Earl was born in Hollywood and started his career designing custom bodies for Tom Mix and Fatty Arbuckle. He brought style, not technical know-how. Differentiation among his cars came

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[23] Judge Ambro makes this point ably in his *Philadelphia Newspapers* dissent. See *In re* Philadelphia Newspapers, LLC, 599 F.3d 298, 320 n.2 (3d Cir. 2010) (Ambro, J., dissenting) (citing Vincent S.J. Buccola & Ashley C. Keller, *Credit Bidding and the Design of Bankruptcy Auctions*, 18 Geo. Mason L. Rev. 99 (2010)). This issue is now before the Seventh Circuit. See River Road Hotel Partners LLC v. Amalgamated Bank, Docket No. 10-3597 (7th Cir. 2010).

[24] Among other things, Jedd did not drive a Model T, but rather a 1922 Oldsmobile.

[25] *See* ROBERT LACEY, FORD: THE MEN AND THE MACHINE 94 (1986).

[26] Lee Iacocca's sporty 1964 Mustang was a triumph of styling. Its Taunus V4 engine was from Ford Germany, while the Ford Falcon and Ford Fairlane were the source of the chassis, suspension, and drivetrain components.

from adornments, not technological innovation. The guts of the cars remained essentially the same and their engineering straightforward. A mechanically inclined high school student could pretty much repair any car on his own.[27]

All of this started to change in the 1970s. Instead of a separate frame and body, unibody construction became the norm. The parts of each became much more integrated. In the 1980s, electronics took over cars. In the 1990s, new materials increasingly replaced sheet metal. Machines that had been not significantly more complicated than the Model T became sophisticated creatures of high technology. We can romanticize the cars of the past, but cars today are better across all dimensions.

These changes were bad news to General Motors. The demand for new cars came from the need to replace old cars.[28] Because new cars were better built and more reliable, they lasted longer and needed to be replaced less often. Technological change brought another shift that disadvantaged manufacturers, such as General Motors, committed to an existing infrastructure: The optimal size of the automobile company became smaller. Improved technology often leads to more vertical integration. We saw this in the automotive industry with the introduction of the Model T. Ford transformed itself from a firm that bought virtually all its components from the outside into its giant River Rouge works, in which iron ore entered at one end and cars emerged at the other.[29] Alfred Sloan worked a similar change at General Motors.[30] But technological change can push in the opposite direction too, and this has been the recent history of the automobile industry.[31] We are in an era of massive vertical deintegration. General Motors is soon to have only 31,000 hourly workers, almost an order of magnitude smaller than what it used to have. Chrysler's workforce has shrunk by a comparable amount.

To be sure, some of the reduction comes from declining production and some from increased automation, but that is only part of the explanation. The workforce has become smaller largely because the amount

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[27] Indeed, Grant Achatz reassembled a 1970 GTO from its component pieces as a sixteen-year-old before putting his talents to other use. See GRANT ACHATZ & NICK KOKONAS, LIFE, ON THE LINE: A CHEF'S STORY OF CHASING GREATNESS, FACING DEATH, AND REDEFINING THE WAY WE EAT 11-14 (2011).

[28] With more cars in this country than licensed drivers, the domestic market is close to being saturated.

[29] For its first model, the Ford Motor Company spent $384 on components and $20 on assembling them. *See* LACEY, *supra* note 25, at 70.

[30] *See* ALFRED P. SLOAN, JR., MY YEARS WITH GENERAL MOTORS (Doubleday 1963).

[31] *See* JAMES P. WOMACK, DANIEL T. JONES & DANIEL ROOS, THE MACHINE THAT CHANGED THE WORLD (Free Press 2007).

of outsourcing has increased. Instead of having one supplier make the speedometer and another a fuel gauge that the auto manufacturer incorporates within the dashboard, today one supplier sells the car manufacturer the entire assembled dashboard. The manufacturer merely attaches it to the car. Instead of sewing the seat covers, today's manufacturer has someone else build the entire seat assembly. These much more substantial components are brought together in an assembly plant that, if optimally designed, is much smaller than its predecessors and employs fewer people.

Moreover, as cars have become more complicated, relevant design and manufacturing expertise is less likely to be found in-house. Supporting a large team of engineers in-house make sense when changes are largely ornamental. All Harley Earl's design team needed was modeling clay. In such a world, a shift from one model to another might require a large investment in new dies to stamp out different pieces of sheet metal, but the same team could design these pieces of metal year in and year out. Today, designing a car requires drawing on many different kinds of expertise in smaller or larger measure. A car manufacturer is less likely to have the expertise needed on its payroll. At the same time, computer-assisted design has made it easier to work for engineers to work with each other at a distance in different firms.

A car company invests in a number of car projects and enjoys its profits from those that prove successful in the marketplace. Gone are the days in which consumers are loyal throughout their lives to a particular carmaker and demand for each can be confidently predicted from one year to the next. Crucial to the success of a car company today is having a number of models in production that are successful in the marketplace and having a number of others in the pipeline. If a car company does not have this, it has few advantages relative to a new entrant, and none relative to an established firm with successful models.[32] Moreover, in this environment, it is important to have the ability to ramp up production when a model proves successful and ramp it down when it does not.

America's comparative advantages change over time and, at some point, it ceases to have any comparative advantage in making a particular type of product. This has happened in the case of televisions, but it has not yet happened with cars. Cars, at least the larger ones, can still be

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[32] A caveat to this is the need to have some distribution system in place. This is in large part the result of legal rules that limit the ways in which cars can be distributed. Saturn, for example, had value only because of the possibility that a new automobile manufacturer would want its distribution network.

profitably designed and manufactured in this country. Some of Toyota's successful products, such as the Tundra, are designed in this country by engineers who began their careers at General Motors, Ford, and Chrysler. The question was not whether there will be American car companies, but rather whether, given these changes, they will include General Motors.

At the time of the sudden collapse in demand for automobiles, General Motors was making its best cars ever. Some models, such as the Malibu, were competitive, and there were new cars in its pipeline. Some were promising even though others, such as the Volt, would never bring any profits. But General Motors had to solve a number of problems if it was to compete successfully against other American car companies.

General Motors had collective bargaining agreements that were hopelessly out of step with existing conditions. Standing alone, they were not an insurmountable problem. The contracts themselves were of relatively recent vintage, and experience in the steel industry showed that unions were willing to make drastic changes in their contracts if the survival of the business turned on it.

The collective bargaining agreements were symptomatic, however, of a much larger problem—deeply embedded norms that were out of step with what it took for a modern automobile company to be successful. That problem would not go away with a different collective bargaining agreement. It was part of a culture in which the way everything was done assumed a method of production that had long passed. General Motors was saddled with an infrastructure that was too large. Everything from its factories to its executive offices was excessive given the optimal amount of outsourcing.

Compounding this problem, General Motors's infrastructure was premised on the idea that it made sense for one company to produce a complete line of cars. ("A car for every purpose and every purse," as Alfred Sloan used to say.) This was easy when cars shared a common platform and many common components. But as cars become increasingly sophisticated, one can no longer make many models with just a few platforms. Firms possessed different competences that change over time. No one firm can be confident that, over time, it will remain adept at building competitive cars at every price point.

General Motors was now best at building large, technically sophisticated cars. Smaller and less complicated cars put a premium on cheap, relatively unskilled labor. Freed of constraints, General Motors might not even make small cars domestically. Unfortunately, this segment of the market is now the one in which there is the greatest demand. Legal regulation compounds the problem. The CAFE standards put in place in the 1970s had a nice virtue. Instead of micromanaging car companies, regulators told them the average fuel economy they were to have across their entire fleets. In a world in which the Big Three made all the cars and each made cars of all types, they bore the burden of making the trade-offs. In a world in which there are more players, each making different kinds of cars, this burden falls disproportionately hard on those like General Motors whose comparative advantage is making bigger cars.

In short, at the start of 2009, General Motors was in terrible shape, even without its legacy costs and collective bargaining agreement. Nevertheless, the disconnect between General Motors's CEO Rick Waggoner and the world around him was completely understandable. Like many managers, he measured the state of General Motors relative to its condition at the time he took the helm. By any measure, the General Motors of 2009 was better than the General Motors of 2000. Waggoner could not believe he could change as much as he had and still have a company that was hopelessly uncompetitive.

General Motors's ability to survive over the long term remains unclear. It requires a wholesale change of well-entrenched norms and a dramatic rescaling of its infrastructure. Even with these substantial modifications, its survival depends on a relatively quick return to historic levels of domestic demand for automobiles as well as the ability to shrink every aspect of its operations dramatically.

General Motors's bankruptcy, like Chrysler's, took the form of an asset sale. The debtor at the time of filing the petition proposed a sale to an identified buyer. The dynamics of the case, however, were altogether different. While Chrysler had no ability to survive as a going concern, regardless of how much money was spent to keep it intact, General Motors had a chance to survive—at a cost that likely exceeded the value of its assets—if it were dramatically transformed. The ability to sell assets in bankruptcy allowed the kind of transformation that was a necessary, though far from sufficient condition for its survival as a going concern.

III. Asset Sales and Senior Creditor Control

At the time General Motors received its first infusion of financial aid in the waning days of the Bush administration, it had relatively little secured debt. As a result, the government's loans, like most loans to financially troubled businesses, were secured. These loans, combined with billions more in debtor-in-possession financing were large relative to the value of General Motors's assets. Indeed in all likelihood, they were greater than the value of these assets. Because the government was both the largest creditor and enjoyed, in essence, a first-priority position,[33] it controlled the bankruptcy process. While *Chrysler* presented the challenge of ensuring the sales process respected the right of senior creditors who did not have control, here the juniors were the ones who lacked control and needed protecting.

The Task Force acted with respect to General Motors the same way as would any other secured creditor. Long past is the day in which the old managers of a financially distressed business called the shots. Well in advance of the bankruptcy petition, secured creditors begin to control the governance of the business.[34] By the time of the bankruptcy petition, the senior secured lenders will already have their hands on the levers. They often replace the CEO. Technically speaking, of course, the secured creditor has no power to replace the CEO, only the board. But as a practical matter, the secured creditor often calls the shots. If it is the only source of debtor-in-possession financing and insists on the head of the CEO as a condition of providing it, members of the board are essentially choosing between keeping the company alive on the one hand or showing loyalty to someone who invited them to a few golf tournaments on the other. It is not a hard call.

In addition to changing the management team, the secured creditors review the various exit options with the board. Among them include having the debtor put up the assets for a quick sale in bankruptcy, either to the secured creditor or to some buyer.[35] The speedy sale that gives little time for rival bids worked to the disadvantage of the dissident secured creditors in *Chrysler*, but in the mine run of cases, it is the device that secured creditors use to the detriment of those junior to them. Because they do not gain from postponing a sale and face all the downside if things go worse than expected, the secured creditors have an incentive to force through a speedy sale.

If the firm is worth less what the secured creditor is owed, there is no problem with a sale being conducted under its aegis. We need to worry, however, that the secured creditor is pushing through a speedy and low-valuation sale even when the assets are worth more than what

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[33] More precisely, the debt that was senior was so small relative to the value of the assets that the creditors who held it were confident of being paid in full and played only a minor role in the reorganization.

[34] There is a growing body of empirical work on this issue. For a representative example, see Greg Nini, David C. Smith & Amir Sufi, *Creditor Control Rights, Corporate Governance, and Firm Value* (2009), available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1344302.

[35] *See* Douglas G. Baird & Robert K. Rasmussen, *Private Debt and the Missing Lever of Corporate Governance*, 154 U. PA. L. REV. 1209, 1209 (2006).

it is owed.[36] The secured creditor and the managers possess private information not available to anyone else. By binding together, they can suppress information about the value of the business.

When the secured creditors want either to sell the firm or acquire it outright with a credit bid, the bankruptcy judge can be put in an impossible position. The business can maintain its ongoing operations only if it can continue to use its existing cash reserves to meet the payroll and acquire new supplies. The reserves, however, are subject to the senior creditor's security interest. The Bankruptcy Code severely limits the ability of the bankruptcy judge to authorize their use.[37] As a practical matter, consent from the secured creditor is required in the absence of someone else willing to make a loan subject to the security interest. The secured creditor appears and asserts that it is willing to consent only if the judge approves the sale on an expedited basis.

Approving the sale offers the bankruptcy judge the path of least resistance. The motion is made on the first day of the case, and the junior creditors will have had little time to organize any opposition. Bankruptcy judges are disinclined to risk shutting the firm down by turning down a motion to which no one has objected. As between having a case disappear from her docket or having it explode into thousands of contentious lawsuits over the wreckage that follows in the wake of a piecemeal liquidation, judges are inclined to favor the former. Judges fear that if they push back too hard, the secured creditor will indeed refuse to finance the business and it will shut down.

Brinkmanship of this sort has become commonplace in bankruptcy court. Conventional game theory models suggest that this bargaining game has multiple equilibria, including one in which the firm liquidates. Assume that Firm is worth $120 if it remains intact and $30 if liquidated. Bank is the senior creditor and is owed $100. Bank has a choice between two strategies. In one, it proposes a speedy sale (one in which it makes a credit bid of $100 and a cash bid of $10) and simultaneously commits itself to rejecting any subsequent bargaining. In the other, it can ask for a speedy sale on the same terms, but prepare to engage in bargaining in the event that the judge pushes back. Such preparation costs it $10. The bankruptcy judge similarly has a choice between a soft and a tough negotiating strategy.

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[36] There is some empirical evidence that this is in fact happening. *See* Kenneth Ayotte & Edward R. Morrison, *Creditor Control and Conflict in Chapter 11,* Columbia Law and Economics Research Paper No. 321, Northwestern Law & Econ. Research Paper No. 08–16) (2008), *available at* http://ssrn.com/abstract=1081661.

[37] See 11 U.S.C. §364.

If the judge adopts the soft strategy, and Bank is committed, the sale goes forward as Bank proposes. In return for its $100 claim and its cash contribution of $10, Bank gets a business worth $120. General creditors receive only $10, even though they are entitled to the difference between what the business is worth and what the secured creditor is owed.

If Bank is willing to bargain and the judge again takes a soft position, the payoffs are the same, but Bank has spent $10 preparing to bargain. If the judge adopts a tough position, and Bank is willing to bargain, Bank nets $90 ($100, less expenses of $10), while the general creditors receive $20. If Bank and the judge both adopt tough strategies, the firm is liquidated. Bank receives $20 (net of expenses) and the general creditors receive nothing.

If we assume the judge acts to maximize the recovery of the general creditors, the game has three Nash equilibria—one in which Bank adopts the tough strategy and the judge adopts the soft strategy; another in which Bank is soft and the judge tough; and the last in which the judge adopts the soft strategy with ⅞ probability and Bank adopts the soft strategy with ½ probability.[38]

These different equilibria capture the problems we face. First is the pure-strategy equilibrium in which the judge acquiesces and Bank adopts a tough strategy. The problem with this equilibrium, however, is that Bank receives more than the $100 it is owed and the rights of the junior creditors are compromised. The second pure-strategy equilibrium is problematic over two dimensions. First, Bank has been forced to bargain and $10 has been lost as a consequence. Second, this rule compromises Bank's entitlements, as it is effectively recovering only $90 (net of costs), when it is owed $100. The mixed-strategy equilibrium is the worst of all worlds, as $100 of value is lost.

We need to ask how to change the structure of this game. We want procedures that protect the rights of junior investors. At the same time, the procedures should minimize the costs of the process and try to ensure that the senior creditors are paid in full. It might seem that we have seen all this before.[39] In the 1890s, most of the railroads in the country were insolvent. They had more debt than they could ever hope to repay.

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[38] The existence of a mixed strategy equilibrium is a common feature of games that have this structure, such as matching pennies, chicken, and hawk-dove.

[39] Ralph Brubaker and Charles Tabb, among others, have pointed this out. *See* Ralph Brubaker & Charles Jordan Tabb, *Bankruptcy reorganizations and the troubling legacy of Chrysler and GM*. U. Ill. L. Rev. 1375, 1400-01 (2010); *Ralph Brubaker, The* Chrysler *and* GM Sales*: §363 Plans of Reorganization?*, 28 BANKR. LETTER, No. 9, at 12 (2009).

There was a huge amount of secured debt and the secured creditors again controlled the reorganization process. Judges recognized the need to police them.

Critics of speedy sales today will likely point to the subsequent evolution of the law. The protections judges devised led to the reforms of the 1930s, the introduction of the absolute priority rule into bankruptcy, and eventually the Bankruptcy Code of 1978. In other words, the existing protections that junior investors enjoy in Chapter 11 evolved out of an effort to ensure that, when the business was sold, especially when it was sold to senior secured creditors, that their rights were protected. In other words, secured creditors today who push for speedy sales are short-circuiting a reorganization process put in place precisely because of the abuses that speedy sales generated.

Under this view, the incremental protections being discovered today for sales under §363 will ultimately lead us back to the protections already embedded in the plan confirmation process in Chapter 11. Rather than wait for these procedures to evolve, we should go to its end point at once. We should limit the availability of sales altogether. We should insist that dispositions of the firm as a going concern go through the plan process. Only the narrowest exceptions should exist for the few cases in which the businesses are in fact "melting ice cubes." The protections built into Chapter 11 are the ones history teaches us are needed to prevent abusive sales. End runs around them are inappropriate. At the very least, the protections junior creditors enjoyed when assets were sold during an equity receivership should remain.

This line of reasoning should be rejected. Today the filing of a bankruptcy petition is a recognition event that collapses future possibilities to present value. This was not the case with the equity receivership. Modern bankruptcy law embraces a regime of absolute priority. By contrast, before 1939, reorganization law adopted a rule of relative priority. In a relative priority regime, the restructuring is not one that collapses future possibilities. The option value of junior interests is recognized even when they are underwater. The procedural rules needed in the two cases are fundamentally different.

In an absolute priority regime, the senior creditor has an incentive to push for an immediate sale, while the junior investor wants delay. Consider another example. Bank has a senior claim for $100. If there is an immediate sale for more than $100, Bank receives $100 with certainty. But let us assume that, there is no sale and the business remains in their hands, there is a fifty-fifty chance the firm will be worth $160 and an equal chance the firm will be worth only $80. If the firm turns out to be worth $160, Bank will still only receive $100, and if it turns out to be worth $80, Bank will receive only that much. Thus, while Bank gets $100 if everything is settled today, it realizes in expectation only $90 if there is delay. Junior investors have exactly the opposite incentive. Bank and the junior investors know a little more than anyone else about the value of the firm in good and bad states of the world. Given their private information, there is no guarantee that a buyer will appear willing to pay as much. Nevertheless, Bank will push for a sale as long as the offer is for more than $100. In contrast, the junior creditors will resist a sale even when there is an offer for more than $120.

The costs associated with an early disposition—the risk of a fire sale[40]—are borne by the junior investors, while the secured creditors bear the risk of asset depreciation that comes with the delay. It may not be possible to have procedures that both ensure a sale for top dollar and at the same time adequately protect the secured creditor's priority position. In theory, of course, the junior investors in our example should be able to offer adequate protection to the secured creditor, as they hold the fulcrum security. (The firm if reorganized rather than sold, it is worth $120 and the secured creditors are owed only $100.) But if the junior creditors face any problems in organizing, it may not be possible. We usually need to make a trade-off between rules that prevent fire sales on the one hand and rules that force junior investors to bear the costs of delay on the other.

This tension between junior and senior stakeholders is simply not the problem that judges faced in trying to police the players in an equity receivership. The equity receivership was a regime of relative priority, rather than absolute priority, and in a relative priority regime the tension between junior and senior creditors largely disappears. One can see how relative priority worked with a variation on the previous example. Bank is once again owed $100. The firm can be sold today. If firm is not sold, there are two possibilities, each appears equally likely. Under one outcome, the firm, as best as anyone on the outside can tell, will be worth $160. Under the other, the firm will be worth only $80.

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[40] Of course, at first blush, a fire sale does not lead to an efficiency loss. The investors as a group receive less, but the assets themselves may still be put to their best use. An investor with a diversified portfolio is indifferent to sale prices when she is equally likely to be a buyer or a seller. As has been observed often before, there are still potential costs. First, the fire sale may not simply yield a lower price. It may also put the asset in the hands of someone who values it less. *See* Andrei Shleifer & Robert W. Vishny, *Liquidation Values and Debt Capacity: A Market Equilibrium Approach*, 47 J. FIN. 1343 (1992). Second, entrepreneurs may be able to raise less capital in the first instance as investors are undercompensated in bad states of the world. *See* Alan Schwartz, *A Normative Theory of Business Bankruptcy*, 91 VA. L. REV. 1199 (2005).

In a relative priority regime, the shares of both Bank and the junior investors are fixed at the outset according to their expected value at the time of the bankruptcy petition. In this example, junior investors would receive one-sixth of whatever was realized and Bank would receive the balance.[41] With their shares fixed, Bank and the junior investors decide jointly on whether to sell Firm or reorganize. Because their claims have been transformed into shares in Firm, the tension that would otherwise exist between junior and senior investor disappears. Both now care only about maximizing the value of the business because their relative shares are fixed.

A regime of relative priority is analogous to the admiralty rule of the general average.[42] If the ship is foundering, those with cargo aboard the ship have their rights to their cargo transformed into a pro rata share of all the cargo on the ship. In this regime, the decision about what cargo to throw overboard is separated from the question of who owns it. A regime of relative priority treats a bankruptcy filing the same way. The need for the different investors to work cooperatively justifies ensuring that the reorganization is not a recognition event. By giving Bank a fixed share of Firm, it will always favor whatever course will maximize the overall value of the firm, as that course will also maximize its own share.

Relative priority has the feature of sharing some of the value of the firm with junior investors even when the assets are not worth enough to pay them in full.[43] Consider the case in which Firm will be worth either $80 or $160 with equal probability, but Bank is owed $140. In a regime of absolute priority, Bank is entitled to the entire firm, as it is owed more than the firm is worth. Not so in a regime of relative priority. In such a regime, Bank receives a share of the company that reflects the probability that it will receive its $140 half the time and only $80 the rest of the time. The expected value of its claim is therefore $110. The firm is

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[41] The best estimate of the value of the business is $120. As Bank is owed $100, $20 of the value is left for the junior investors. The difficulty of designing a mechanism that gets the initial valuation set in a way that does not distort the incentives of the parties had long been thought to a stumbling block to implementing a relative priority regime in the absence of the strong norms that existed during the equity receivership.

[42] Jackson and Scott were the first to invoke the analogy of the rule of the general average in bankruptcy. *See* Thomas H. Jackson & Robert E. Scott, *On the Nature of Bankruptcy: An Essay on Bankruptcy Sharing and the Creditors' Bargain*, 75 VA. L. REV. 155, 164–78 (1989).

[43] *See* Douglas G. Baird & Robert K. Rasmussen, *Control Rights, Priority Rights, and the Conceptual Foundations of Corporate Reorganizations*, 87 VA. L. REV. 921 (2001)

worth $120, and Bank receives 11/12ths of the business and the junior investors receive 1/12ths.

A relative priority regime is one in which the restructuring preserves the option value of the junior interest, even when that interest would be wiped out if there were a sale or some other event that collapsed all future possibilities to present value. The valuation does not have the same knife-edge character as it does in an absolute priority regime in which a small change in interest rates can affect whether a class is in money or wiped altogether. In a relative priority regime, the bankruptcy restructuring leaves unaffected the value of each investor's claim against the firm. All of the players want to chart a course that is wealth maximizing. The players had no reason to hide information from each other. Junior and senior creditors do not have conflicting interests. They can even hire the same lawyer to represent them.[44]

Since the 1930s, relative priority regimes have enjoyed a poor reputation among bankruptcy academics. Partisans of absolute priority from William O. Douglas to Alan Schwartz have insisted that only absolute priority regimes vindicate the creditors' bargain and maximize the capital that entrepreneurs can raise in the first instance. "Deviations" from absolute priority are tolerated only to the extent needed to overcome the bad incentives that exist in the reorganization process.

Relative priority regimes suffered both because its advocates were practicing lawyers (principally Paul Cravath and Robert Swaine) who were thought to be biased. Moreover, relative priority regimes were implemented through norms that were not transparent and on that ground suspect as well. In the absence of a well-developed understanding of options, it was hard to explain exactly what a relative priority regime was and, until recently, the conventional wisdom had been that such a regime could not be implemented.[45]

Relative priority regimes today have few defenders.[46] Nevertheless, we may be selling them short. Relative priority emerged in a largely

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[44] In the *Atchison, Topeka and Santa Fe* reorganization, for example, the same lawyer represented both the first- and second-lienholders simultaneously, and no one seemed to have thought it problematic. I asked one of this lawyer's partners about the apparent conflict of interest, but he refused to discuss the matter, invoking the attorney-client privilege. As recently as 2009, the firm represented the railroad.

[45] As is too often the case, the conventional wisdom was wrong. *See* Anthony J. Casey, *The Benefit of the Creditors' Bargain: Option-Preservation Priority In Chapter 11*, 77 U. CHI. L. REV. ●●● (forthcoming 2010).

[46] Indeed, among law and economics scholars who adhere to the standard Jackson creditors' bargain model, Tony Casey stands conspicuously alone. *See* Casey, *supra* note 45.

contractual regime in which sophisticated parties were on both sides of the transaction. It was abandoned largely as a result of meddling by a bankruptcy professor at the Yale Law School who did not seem to have understood relative priority and who was in any event utterly clueless about the advantages such a priority regime brought with it.

This is a familiar story that has been told elsewhere.[47] What matters for our purposes is that the procedural protections that judges cared about at the end of the nineteenth century have nothing to do with the rules now needed to police sales in bankruptcy as the priority regimes are fundamentally different. Indeed, some of the rules developed during that period—in particular looking with suspicion on any plan that leaves some people out in the cold—have lost their purpose.

As it first developed, only the key players enjoyed the benefits of relative priority. Creditors whose collateral consisted of a spur line that the railroad no longer needed might be left out in the cold. The rules for including and excluding the players were norm-based and not transparent to the outside. Ultimately, the Supreme Court insisted that every claimant participate and enjoy the option value of their underwater claims.[48] Skipping over any claimant was not permissible.

But in an absolute priority regime, out-of-the-money claims are not entitled to anything. Option value is not recognized. Hence, there is nothing *substantively* the matter with it in an absolute priority regime. The holder of the fulcrum security has the right to ignore everyone, while in a relative priority regime it must take everyone into account. In an absolute priority regime, a gift to a junior class becomes problematic only if it is used to corrupt the reorganization process.

The challenge under absolute priority then is distinguishing between situations in which the payoff to some, but not all of the junior interest holders is done because the senior claimant finds it in her interest as the owner of the firm and those situations in which the payoff is the device that the senior claimant uses to become the owner of the

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[47] *See* DAVID A. SKEEL, DEBT'S DOMINION: A HISTORY OF BANKRUPTCY LAW IN AMERICA (2001); Baird & Rasmussen, *supra* note 13.

[48] The Supreme Court held that their interests had to be taken into account, but did not explain how their shares were to be calculated. *See* Northern Pacific Railway v. Boyd, 228 U.S. 482, 508 (1913) (noting with elaboration that a creditor's "interest can be preserved by the issuance, on equitable terms, of income bonds or preferred stock. If he declines a fair offer he is left to protect himself as any other creditor of a judgment debtor, and, having refused to come into a just reorganization, could not thereafter be heard in a court of equity to attack it.")

firm.[49] The rules designed for a relative priority regime may do a bad job of this. In all events, Chapter 11 stands at a crossroads. We have two different paths—reorganization and a sale—and two different mechanisms to police abuse from the senior secured creditor who exercises control.

In a reorganization, the junior claimants are protected through a valuation mechanism and an anti-gifting rule. It would simply not have been possible to reorganize Chrysler or General Motors and protect the retiree pension programs as part of a plan of reorganization.[50] By contrast, there are no rules that prevent them if there is a sale, beyond the general ability of the bankruptcy judge to oversee the sale and deny approval if she believes that abuse is present. The contrast between the two regimes reflects the relative infirmities of rules and standards respectively. More to the point, the choice between sale or reorganization should turn on the route that maximizes the value of the estate. The party in control should not be choosing one route rather than another merely because one permits gifting and the other does not.

The anti-gifting rule in a traditional reorganization is emblematic of a much larger problem. The judge must value the assets in an adversary process where some of the players have private information and others do not.[51] The anti-gifting rule, originally designed to ensure a distributional outcome in a relative priority regime, is only weakly correlated with ensuring that the valuation is done correctly. There are any number of other reforms to reorganizations that do more to solve the problem. These range from mimicking approaches to valuation that parties take in private contracts.[52] Alternatively, as Richard Hynes as pointed out, a reorganization regime can require a judge to set an expiration date on the junior creditor's option instead of requiring her to value the assets. Such a restructuring regime avoids the liquidity problems of an actual sale or Bebchuk options, and, unlike standard reorganization re-

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[49] Brubaker and Tabb make this point. *See* Brubaker & Tabb, *supra* note 39, at 1396-97.

[50] *See In re* DBSD North America, Inc., —F.3d —, 2011 WL 350480 (2d Cir. 2011).

[51] For an analysis of decisionmaking in such contexts, see Paul Milgrom & John Roberts, *Relying on the Information of Interested Parties*, 17 RAND J. ECON. 18 (1986).

[52] *See, e.g.*, Keith Scharfman, *Valuation Averaging: A New Procedure for Resolving Valuation Disputes*, 88 MINN. L. REV. 357, 364-65 (2003) (describing contractual valuation mechanisms using expert appraisers in the Merck/Schering-Plough and Verizon/Vodafone joint ventures).

gimes, it puts more modest demands on the bankruptcy judge than a full-scale valuation.[53]

It is unlikely, however, that reorganization regimes will supplant swift going-concern sales of the sort witnessed in *Chrysler* and *General Motors*. If the firm is losing money on an operating basis and the secured creditor (whether J.P. Morgan or the United States government) is the only one willing to finance the bankruptcy, the bankruptcy judge must act quickly in an environment in which her ability to protect junior parties is limited. She may be forced to choose between either liquidating the business or agreeing to whatever sale procedures that the secured creditor demands. An anti-gifting rule or other rules structuring the sale process may obscure the underlying problem.

Return to the bargaining game set out above. This game is embedded inside a larger game. The procedures available to sell the assets and the options available to the bankruptcy judge turn in large part on the actions of the secured creditor before the bankruptcy began. We can have two cases in which Bank comes in and proposes to sell the assets for $100 to the same buyer and sets out identical procedures for what someone else must do to make a topping bid, and the two cases can be radically different. We need to know what happened before the bankruptcy began.

If the firm has been shopped and if all the options (including liquidation options) have been completely explored, extensive procedures in bankruptcy are not necessary and whatever cursory procedures that secured creditor poses are likely unobjectionable. On the other hand, if the secured creditor has done too little before bankruptcy, allowing it to jam through a sale is inherently problematic, especially if it is credit-bidding.

Bankruptcy rules need to provide the proper incentives in the period leading up to bankruptcy. One might consider tying the hands of bankruptcy judges. Imagine, for example, that the legal rule that allowed the bankruptcy judge to authorize a speedy sale only if, but only if the firm has been adequately shopped prepetition. If the firm has not been adequately shopped, an extended sales process is mandatory. If additional resources are needed to keep the firm running, the secured creditor can provide them. If the secured creditor is unwilling, the firm will be liquidated.

A liquidation might yield substantially less than the offer on the table at the time of the filing of the petition. Everyone loses, of course, if

[53] *See* Richard M. Hynes, Redeeming Reorganization (Jan. 11, 2011) (unpublished manuscript, University of Virginia).

things come to this. But if the bankruptcy judge's hands are tied and the secured creditor knows in advance that they will be tied, then it will ensure that the firm was adequately shopped before bankruptcy. Because the secured creditor no longer has the ability to play a game of chicken with the bankruptcy judge, it will lay the ground work before the petition is filed. Or so the theory goes. One may doubt whether such hands-tying rules work. Most efforts to adopt a strict policy of never-negotiate-with-terrorists break down.

IV. Conclusion

Chrysler and *General Motors* expose foundational issues in the law of corporate reorganizations. One can fault the bankruptcy judges in these cases for not insisting on more procedures and in particular for not insisting that liquidating bids be affirmatively welcomed, but it would not likely have affected the outcome in *Chrysler* and would have been entirely symbolic in the case of *General Motors*. As long as we remain committed to the absolute priority rule, the central question is one of designing a mechanism that induces everyone, before the filing and afterwards, to take steps that ensure that the firm is sold for top dollar. In the end, the choice is not whether we regulate sales more, but how we do it. This may turn in part on such questions as how much the hands of a bankruptcy judge can be tied without interfering with her ability to manage the case.[54]

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[54] A hands-tying strategy could be implemented either through rulemaking or legislative action.

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